

SUBJECT: Priority of Future Advances

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INTRODUCTION

This release applies to all credit unions, state and federal, engaged in real estate lending. It describes steps credit unions can take to protect the priority of their mortgage liens.

EXECUTIVE SUMMARY

Future advance clauses permit a mortgage to secure new funds advanced years after the original mortgage was recorded, so long as the total outstanding indebtedness does not exceed the original loan balance. The League's mortgage forms presently include future advance clauses.

However, before a credit union makes a loan in reliance on a future advance clause, the credit union must examine the circumstances to determine if its advance will have lien priority over other liens which may have been recorded in the intervening years since the mortgage was recorded. This release explores priority issues, depending on whether the advance is optional, protective, obligatory, or an advance on a construction mortgage.

The release also emphasizes the importance of credit unions providing written notice to all first (or other senior) mortgage holders when the credit union records a second (or other junior) mortgage. Without this precaution, the credit union risks losing its lien priority to any optional future advances by the first mortgage holder.

DEFINITIONS

What is a future advance clause? Simply stated, a future advance clause is a statement within a real estate mortgage that the mortgage secures not only the original note, but additional advances of funds. This allows the credit union to make an add-on loan without having to record a new mortgage.

When a mortgage document does not contain a future advance clause, the credit union must completely rewrite the mortgage each time an add-on loan is granted. Lacking the proper language, a mortgage does not secure future advances.

The League's Consumer Real Estate Mortgage (#82020) has had an optional future advance clause since 1976. The Business Real Estate Mortgage (#81098) has had one since at least 1984. Finally, the Real Estate Mortgage (Non-Consumer) (#82043) has included a future advance clause since March 1987. Look in the "Mortgage as Security" section of the form.

Optional advances

Optional advances are those which the credit union does not have to make. One example could be if the credit union approves a \$10,000 home improvement loan when the member's original \$80,000 mortgage has a \$40,000 balance. The \$10,000 loan is underwritten at the time of the request.

Protective advances

Protective advances are a special type of advance. The credit union makes the advance to protect its security interest (e.g., paying delinquent taxes or hazard insurance in order to protect the credit union's collateral).

Obligatory advances

Obligatory future advances are those that the credit union commits to in advance. Examples include the advances committed to under a R.E.A.P.[®] agreement or a construction loan agreement. With those loan programs, the credit union must make the advances if the conditions in the agreement are met. Thus, The League's R.E.A.P.[®] open-end line of credit mortgage obligates the credit union to make future advances, up to the credit limit and with certain limited exceptions. These obligatory advances merit special discussion later in this release.

CONDITIONS FOR GRANTING A FUTURE ADVANCE

The future advance clause applies only under certain conditions. The total sum of the new advance plus the present balance cannot exceed the amount specified in the original mortgage. Any excess is unsecured. This can best be illustrated by the following example:

Mary Member takes out a \$100,000 first mortgage real estate loan with the credit union. After a number of years of repayment, the balance decreases to \$65,000. Mary decides to remodel one room of her residence for a cost of \$10,000 and to consolidate some of her debts for another \$4,000. Upon qualifying for the additional \$14,000 advance, she may acquire the funds from the credit union.

Note that Mary has not exceeded the original amount specified in the mortgage (\$100,000). The total indebtedness on her first mortgage is now \$79,000 (\$65,000 plus \$14,000 advance).

HOW AN ADVANCE IS GRANTED

In reliance on a future advance clause, the credit union can rewrite the note, Truth in Lending disclosure statement, and any other compliance documents. The future advance does not require execution of a new mortgage. In our example above, if the \$14,000 advance is handled in this manner, Mary would continue to have only one monthly installment due on her first mortgage loan. The new note and disclosure would reference the original mortgage. The original note should not be marked "paid" but rather "paid by renewal."

Under a less commonly used alternative, the credit union might choose to grant a "side" loan. This is a new loan in addition to and separate from the original note. This side loan, in the amount of \$14,000, would require a new note, Truth in Lending disclosures, and other compliance documents. The new note and disclosure would reference the original mortgage. The old note and disclosures would continue to apply to the original loan, which remains outstanding. Under this method, Mary would have to make an additional monthly payment to the credit union.

With The League's R.E.A.P.[®] home equity line of credit documents, a new agreement is not necessary for "obligatory" future advances. The agreement states that [the borrower\(s\) have the right to take](#) advances from time to time, up to the credit limit. R.E.A.P.[®] operates very similarly to The League's Kwik-Cash plan in helping credit unions avoid rewriting a note for each advance. [But with R.E.A.P., unless a stated exception applies, the credit union must honor requests for advances during the agreed draw period, up to the credit limit.](#)

PRIORITY OF CREDIT UNION AND CERTAIN OTHER MORTGAGES UNDER WIS. STATS. §706.11(1)

In Wisconsin, a mortgage executed to a state or federally chartered credit union is among those granted a special priority status under Wis. Stats. §706.11(1). Upon being duly recorded such a mortgage will have priority over all liens (filed *after* the recording of the mortgage) upon the mortgaged premises and the buildings and improvements thereon, except:

- Tax and special assessment liens filed after the recording of such mortgage, and
- Various environmental or remediation-related liens by the Wisconsin DNR, as provided in Wis. Stats. Ch. 292.

The statute offers the same priority status to each of the following:

- a. Any mortgage executed to a federal savings and loan association or state or federal savings bank,
- b. Any mortgage executed to the Wisconsin Department of Veterans Affairs (DVA) under s. 45.352, 1971 stats. (veterans housing loans), but not a 2nd mortgage assigned to or executed to the DVA under s. 45.80 (4) (a) 1., 1989 stats., or s. 45.37 (3).

- c. Any mortgage assigned to or executed to any of the following:
 - 1. The United States, this state or a county, city, village or town in this state, or an agency, department or other formally constituted subunit of any of the foregoing.
 - 2. The Wisconsin Health and Educational Facilities Authority (WHEFA) created under ch. 231, the Wisconsin Housing and Economic Development Authority (WHEDA) created under ch. 234, or any other authority created by state law.
- d. *Any mortgage executed to a state or national bank or to a state or federally chartered credit union.*
- e. Any industrial project mortgage executed under s. 66.1103 to a trustee (as defined in s. 66.1103 (2) (n)).
- f. Any mortgage executed to a mortgage banker (as defined in s. 224.71 (3)).
- g. Any mortgage executed to an insurer licensed to do business in this state.
- h. Any mortgage executed to a licensed lender, under s. 138.09.
- i. *Any mortgage executed on or after February 2, 2020 to an institution chartered by the federal farm credit administration under 12 USC 2002 (a) that is part of the federal farm credit system created under 12 USC 2001 to 2279cc.*

State savings and loan associations have the priorities specified under s. 215.21(4).

The priority status described above is a significant tool, but not complete protection against the risks posed by construction liens and judgment liens. The special priority status described above does not by itself insure the priority of later advances by the credit union. *See [Priority of Later Advances](#) below.*

Wisconsin law provides that any person who performs, furnishes, or procures any work, labor, service, materials, plans, or specifications, used or consumed for the improvement of land, and who complies with s. 779.02, has a lien therefor on all interests in the land belonging to its owners.

State law generally provides for prime contractors to provide a special notice to the homeowner and lender in any written contract.

PRIORITY OF LATER ADVANCES

Lien priority is a critical issue for a credit union evaluating whether to grant a future advance on a loan. Lenders sometimes leave little or no equity cushion. In the event of a foreclosure sale, there may not be enough money to pay off all lienholders. Court costs and attorney fees get paid before subordinate lienholders. When bad times hit, nationwide or locally, housing values may drop, turning loans thought to be safe into “losers.”

Optional advances

It is critical for lenders to understand who gets paid first in the event of a foreclosure sale, especially when future advances are involved.

Consider a Wisconsin case in which Heritage Bank recorded a first mortgage with an optional future advance clause. First Interstate Bank took a second mortgage on the property later, and properly recorded its lien. Eventually, Heritage granted additional optional advances, secured by its mortgage. At some point, First Interstate assigned its mortgage to a man named Sterbin. Later, when the property was foreclosed, the proceeds were insufficient to pay all of the mortgagees.

Sterbin did not prove that Heritage knew, at the time of an additional advance, about First Interstate’s intervening lien (now held by Sterbin). Instead he argued that Heritage “should have known” about the lien, since it was properly recorded in the public records, and that Heritage’s future advances should therefore lose their priority to the First Interstate lien.

The trial court disagreed with Sterbin. The court ruled that Heritage Bank’s future advances had the same priority as its first mortgage since Sterbin had never proven Heritage actually knew about the First Interstate mortgage.

The decision was upheld on appeal. The Court of Appeals stated “We agree with the circuit court that, in today’s business and commercial world, it is more reasonable to place the burden on the subsequent mortgagee to protect

its security. The circuit court deemed it appropriate to require the second mortgagee to give actual notice to the prior mortgagee of the second mortgagee's security interest."

Thus, in Wisconsin, as in most other states, an optional future advance has priority over an intervening lien unless the mortgage holder has actual knowledge of such lien at the time it makes the advance. [Wis. Stats. § 706.11\(1m\)\(b\)](#).

Junior Mortgage Holder Strategy

As a result of the above priority rule, a junior mortgage holder credit union should always send a notice of its lien to any superior mortgage holder. Proof of this notice should cut off the priority of any later optional advances by the senior lienholder. A sample notice is provided in Exhibit A at the end of this release. This notice will not give the credit union priority over later protective advances by the senior lienholder.

As discussed below, a junior lienholder will still lose priority to obligatory advances by the senior lienholder. When underwriting a junior mortgage loan, the credit union should calculate available equity based on the credit limit of an obligatory advance or open-end mortgage, rather than merely the current balance.

Senior Mortgage Holder Strategy

When a credit union receives actual notice of a junior lien being recorded, it should note in its records that any optional advance it grants will lose priority to the intervening lien. Thus, only make the additional advance if enough equity remains after adjusting for the intervening lien's priority. Actual knowledge might come in any form, such as a title search, a letter from the intervening lienholder, or perhaps the borrower's disclosure of debts and encumbrances on the loan application.

And yes, it is still [common](#) to do a title search before making a future advance! There is always the possibility that an intervening lienholder provided actual notice to the credit union [or the credit union learned of the lien in a loan application or a credit report](#), without notice being forwarded to the loan file.

Obligatory advances

Obligatory advances, such as those made under a R.E.A.P.® [or other](#) home equity line of credit ([HELOC](#)) [or other commitment to advance funds secured by a mortgage](#), may retain the priority of the mortgage document under certain conditions.

The R.E.A.P.® [or other HELOC](#) lender retains priority under Wisconsin law for advances it had committed to in the R.E.A.P.® agreement, even if it makes advances after a default or other event outside of its control relieved the lender of the obligation to advance funds [under the loan agreement](#). [Wis. Stats. § 706.11\(1m\)\(a\)1 and \(1m\)\(b\)1](#).

Again, a credit union recording a mortgage that is junior to an obligatory advance loan should calculate its equity position based on the senior loan's maximum balance, not the current balance.

Protective advances

A protective advance is an advance made for the reasonable protection of the mortgagee's interest, [including](#) the credit union's payment of real property taxes, property insurance, or assessments or other maintenance charges under a condominium declaration, [or a restrictive covenant](#). [A protective advance is often made](#) when the borrower has failed to make the payment on his own. A protective advance [generally](#) has the same priority as the mortgage that secures it, even if that lender is aware of a subordinate lien. [Wis. Stats. § 706.11\(1m\)\(b\)2](#).

Construction advances

Wisconsin law provides that any person who performs, furnishes, or procures any work, labor, service, materials, plans, or specifications, used or consumed for the improvement of land, and who complies with § 779.02, has a lien therefor on all interests in the land belonging to its owners.

But the credit union's construction advances after the filing of its construction mortgage can retain priority over construction liens of those providing work or material on a project.

A "construction mortgage" includes a credit union mortgage that secures an obligation incurred for the construction of an improvement on land, including the acquisition cost of the land.

An advance of funds, including accrued but unpaid interest on the advance, that is secured by a credit union's duly recorded construction mortgage and that is made after the mortgage has been recorded **generally** has the same priority as the mortgage regardless of when the advance is made, if:

- the recorded mortgage clearly states on the first page that it is a construction mortgage, and
- the advance is made to enable completion of the contemplated improvement on the mortgaged premises.
Wis. Stats. § 706.11(1m)(a)2 and (b)3.

Please see *ii Release No. B020: Basics of Construction Lending* for more about construction lending.

SUBORDINATION AGREEMENTS

Sometimes two mortgage lenders agree between themselves to alter the general rules of mortgage priority by executing a subordination agreement. Credit unions should always carefully weigh this as a business decision. The degree of subordination depends upon the language used in the agreement, so is subject to negotiation.

For example, the standard form (WBA 429) used by many Wisconsin financial institutions provides three different options.

- Under option (a), the party labeled as the “Mortgagee” subordinates to the party labeled as the “Lender,” but only to the extent of a specified balance on a named note, including renewals, extensions, and modifications, but not future advances.
- Under option (b), the Mortgagee subordinates to the Lender to the extent of a stated dollar amount plus interest, without reference to any particular note.
- Finally, under option (c), the Mortgagee subordinates to the Lender as to any present or future credit, without limitation.

Thus, the credit union must carefully read the subordination agreement before signing, to be sure that the language of the form, as completed, puts the credit union in a satisfactory position. Take care not to confuse when the credit union intends to be the Mortgagee as opposed to the Lender. On the WBA form, the Mortgagee subordinates to the Lender.

The standard form is preferred over in-house forms which may be poorly drafted, leading to uncertain results.

Of course, a subordination agreement does not affect other lenders who have not signed the form. An executed subordination agreement should be recorded in the Register of Deeds office where the mortgage was recorded.

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League publications are designed to provide accurate information with regard to the subject matter covered, with the understanding that The League does not render legal services. If you have general questions regarding this release, please call The League at (608) 640-4050 if local; or (800) 242-0833. For specific legal advice, please consult your credit union's attorney.

Legal Affairs Department

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EXHIBIT A - NOTICE OF MORTGAGE LIEN

[INSTRUCTIONS: Send two copies of the letter by certified mail, return receipt requested. Save the copy until the credit union loan is paid in full.]

[Credit Union Letterhead]

Notice of Mortgage Lien

[Date]

[Lender's name]

[Address]

Dear Sir or Madam:

Please take notice that [insert names of mortgagors] have granted a real estate mortgage against their property to [ABC Credit Union] The property is located at [insert street address], more particularly described as:

[insert exact legal description]

Our recorded mortgage will have priority over any optional advances your institution may grant secured by the described property.

Sincerely,

Signature

Title